Is gold's price drop just the beginning?

AP Photo/Newmont Mining, File

(MoneyWatch) The collapse in the price of gold has surprised many investors, but it really shouldn't be for those who know their financial history.

Gold closed at an all-time high of $1,895 on Sept. 5, 2011. While it had dropped to $1,690 a year later, an upward swing caused many to predict that gold was again on the rise. Those predictions and the almost uninterrupted rally since 2002, when the precious metal was trading below $300, drove investor interest in gold. As the price continued to soar, gold became so popular that a 2011 Gallup poll found that 34 percent of Americans said gold was the best long-term investment, far more than chose real estate, stocks or bonds. For anyone with a memory of the tech bubble, that should have been a warning, as individual investors almost always get it wrong, being late to the party.

Is the gold rally over?

Ignore the "buy gold now" crowd

Gold has now fallen to just over $1,400 per ounce, and holdings of SPDR Gold Trust (GLD) hit their lowest mark since November 2009. At least some investors must now be concerned about the idea that gold is a good store of value. For those who know their history, the drop is reminiscent of what happened to gold after hitting its peak close of $850 on Jan. 21, 1980. By April 3, 1980, it had dropped all the way to $486. It recovered to $590 by year's end, but closed the following year at just $398 and languished for the next 20 years. In real terms, the price of gold fell about 85 percent from its peak before bottoming out in 2002.

While the "gold bugs" often cite as a basis for the predictions that the real price of gold based on its 1980 peak of $850 would be well over $2,000, that's choosing as their basis the peak of a bubble. That's the equivalent of basing a forecast on the Nasdaq using the March 9, 2000 peak of more than 5,000 as your base and saying the Nasdaq is way undervalued. I don't think anyone would make that argument, yet it's made all the time about gold.

There's also the fact that gold has a strong tendency to revert to a real return of zero. If that's true, gold could end up falling a lot further, as research by economists Campbell Harvey and Claude Erb shows.

Here's another warning. Momentum is the tendency of assets that have done well recently to continue to do well for a while longer, and vice versa. It has been well documented across a wide range of assets. Clearly the momentum in gold is negative. Here's another fact to consider. Momentum is a short-term phenomenon, and it doesn't bode well for gold. It's also important to remember that momentum leads to reversals in the long term -- assets that performed well over a long period tend to subsequently underperform, and vice versa. Another warning as gold soared over the past decade.
It's important to acknowledge that I didn't forecast the collapse of the price of gold. In fact, while not shocked by the price drop, I was surprised that it came without the Federal Reserve's tightening monetary policy. It was Fed Chairman Paul Volcker's decision to drive up real interest rates that led to the demise of gold in 1980. And it was Fed Chairman Alan Greenspan's decision to suppress rates in 2003 that led to gold's resurrection. But, again, my crystal ball is always cloudy.

With that said, my advice remains the same. If you invest in gold because you value the diversification benefits gold can provide -- hedging the risks of loose monetary policy and some geopolitical events -- it's perfectly appropriate to have a small part of your portfolio in gold as part of your asset allocation plan. Just be sure that you are disciplined in rebalancing, not one who gets caught up in the noise and emotions the noise can create. That's the only way you get gold's diversification benefits. On the other hand, if you're a speculator, forewarned is forearmed: Paraphrasing Winston Churchill, the collapse of gold might not be at its end. It might not even be the beginning of the end. It just might be the end of the beginning.

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